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October 20, 2008

AGENDA ITEM 4

TO: MEMBERS OF THE INVESTMENT POLICY SUBCOMMITTEE

- I. SUBJECT:** Synthetic Enhanced Equity Strategy
- II. PROGRAM:** Total Fund
- III. RECOMMENDATION:** Recommend to the Investment Committee
 - a. Approval of the revised Statement of Investment Policy on Low Duration Fixed Income
 - b. Approval of the revised Statement of Investment Policy on Internally Managed Global Enhanced Equity Strategies
 - c. Approval of the revised Statement of Investment Policy on Development of Derivatives Strategies

IV. ANALYSIS:

Background

At the August 18, 2008 Investment Committee meeting, staff presented Item 4b, Enhanced Equity Portfolio – Internally Managed. This item outlined a proposal for the Global Equity team to manage a new enhanced equity portfolio in partnership with the CalPERS' Fixed Income team. The strategy involves combining a portfolio of undervalued fixed income securities with an equity index derivative position to provide an enhanced return. This strategy will be managed with a finite life expectation of three years. Staff is requesting Investment Committee approval to manage this strategy at the October 20, 2008 meeting in Agenda Item 3b. In the event the Investment Committee approves the implementation of the strategy, staff is presenting this item to gain approval of the

pertinent policy revisions. Staff did not wish to wait until the December 15, 2008 Policy Subcommittee meeting as, in order to be meaningful, the implementation of this new strategy is time sensitive.

Management of this strategy requires revisions to three separate CalPERS' Investment Policy Statements. In each case the amendments made were additions with no substantive deletions.

Wilshire's opinion letter is included as Attachment 1.

- Statement of Investment Policy for Low Duration Fixed Income Program (Attachment 2)
 - The addition of a portfolio size assumption for the purposes of calculating portfolio diversification limits during portfolio ramp-up.
 - Insertion of the Synthetic Enhanced Equity Strategy under the approved uses for the High Quality LIBOR Program.
- Statement of Investment Policy for Internally Managed Global Enhanced Equity Strategies (Attachment 3)
 - A benchmark for the Synthetic Enhanced Equity portfolio was added.
 - An investment approach was added identifying portfolio lifetime, risk control, and portfolio construction.
- Statement of Investment Policy for Development of Derivatives Strategies (Attachment 4)
 - Addition of language clarifying that market index based derivatives will be based on the mainstream index and not the custom CalPERS index. Though this will give CalPERS exposure to certain securities it does not directly invest in, the following risks will be significantly reduced: counterparty credit risk, liquidity risk, operation complexity, and pricing.

The proposed revised Policies are attached. Unless otherwise noted, the revised Policies are presented as black-lined versions from the last adopted policy by the Investment Committee. The black-line uses strike-out to indicate deletions and double underline to indicate additions. Single underline does not indicate a change; rather it indicates that the term is defined in the glossary.

V. STRATEGIC PLAN:

This item will further the following goals of CalPERS Strategic Plan:

- Goal VIII. Manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions.
- Goal IX. Achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

The primary expected benefit of the strategy would be the excess returns anticipated to be generated. Additional benefits will be fostering teamwork and synergy across CalPERS' asset class teams and furthering staff knowledge. Existing staff and resources are sufficient to manage the strategy.

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